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In the Supreme Court of the United States

OCTOBER TERM, 1975

TULIA FEEDLOT, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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Petitioner seeks review of the decision in this income tax case that fees paid by it to its shareholders were not deductible business expenses under Section 162 of the Internal Revenue Code of 1954. The court of appeals concluded that petitioner failed to present evidence essential to finding that the fees were ordinary and necessary business expenses and were reasonable in amount.

The pertinent facts are as follows: Petitioner is a closely held corporation which operates a cattle feedlot. During 1970, petitioner had 13 principal shareholders, 11 of whom were directors who each owned 280 shares, and two of whom each owned 140 shares (Pet. App. A 1a-2a; Pet. App. B 13a).

Petitioner fed cattle owned by both its customers and itself. Because the purchase of cattle and feed required large amounts of credit, petitioner's principal shareholders have routinely guaranteed its indebtedness. The amount of the indebtedness guaranteed by each principal shareholder was proportionate to his percentage of ownership (Pet. App. A 2a-3a; Pet. App. B 12a-13a).

From 1964 until 1970, the principal shareholders guaranteed petitioner's indebtedness without compensation. Some principal shareholders were dissatisfied, however, because petitioner, which began the 1970 taxable year with retained earnings of $318,-395.27, had never declared a dividend. As a result, in July, 1970, just prior to the end of petitioner's taxable year, petitioner's board of directors voted to increase the amount of each shareholder's guaranty to $150,000, and to pay to each shareholder-guarantor an annual fee equal to three percent of the amount he had guaranteed. For the taxable year 1970 petitioner paid $54,000 in guarantors' fees to its principal shareholders (Pet. App. A 2a-4a).

Petitioner claimed the $54,000 as a deduction and reported a loss of $6,309.07 on its 1970 income tax return. On audit, the Commissioner of Internal Revenue determined that the fees were in fact a distribution by petitioner of a nondeductible dividend to its shareholders (Pet. App. A 4a, 10a; Pet. App. B 13a).

In this refund suit, the district court upheld petitioner's claimed deduction, concluding that the fees were ordinary and necessary business expenses and were reasonable in amount (Pet. App. A 1a; Pet. App. B 16a-18a). The court of appeals reversed. It concluded that the findings of the district court were clearly erroneous because petitioner failed to present evidence that the guarantee payments were ordinary and necessary and that they were reasonable in amount (Pet. App. A 8a-11a).

The court of appeals correctly held that petitioner presented no evidence to show that it was customary for a cattle feedlot's shareholders to charge a fee for their guaranties, or to show what fees, given the risks involved, would be reasonable in the circumstances of this case, and that the absence of such evidence was fatal to petitioner's claim.[1] As that court stated, "In the absence of such evidence, the

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[1] The court of appeals further observed, however, that even the presence of such evidence would not compel judgment for petitioner (Pet. App. A 9a):

> The presence of evidence demonstrating that it is customary for businesses of Tulia Feedlot's size, type, and financial status to pay a 3 percent guaranty to their shareholder-director-guarantors would not, of course, be dispositive. A whole segment of the business community may profit from this method of paying dividends to their corporate principals without the burdensome necessity of declaring a corporate dividend that is twice liable to federal income taxation.

district court could not properly find that the guaranty was an ordinary and necessary business expense because it could not be sufficiently informed as to the economic realities of the transaction" (Pet. App. A 8a-9a).[2]

The lack of any evidence to show how the three-percent figure was determined is particularly significant in this case where a closely held corporation had retained earnings in excess of $300,000 and some shareholders were dissatisfied about the lack of dividends. Moreover, the shareholders extended the guaranties in direct proportion to their percentage interests, which is a strong indication that the fees in question were nondeductible dividend distributions. Although the three-percent fee was the lowest amount that the dissatisfied shareholders would accept, it did not reflect an analytical calculation of the risks involved in the guaranties. Indeed, two shareholders actually guaranteed amounts in excess of their respective net worths (Pet. App. A 2a-4a).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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[2] Contrary to petitioner's assertion (Pet. 4), this decision is not in conflict with any decision of this Court. The court of appeals (Pet. App. A 5a-6a) followed the decisions of this Court which construe the phrase "ordinary and necessary" of Section 162.

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